

## **Fiscal Responsibility Laws for Subnational Discipline: The Latino Experience**

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*Summary:* This paper discusses Fiscal Responsibility Laws in Latin America, with special attention to their part concerning subnational governments. It discusses why and when such laws might be useful, and when they could be counterproductive. It examines the cases of Argentina, Brazil, and Colombia, as well as the case of Mexico where other types of laws and regulations aim to achieve the same objectives of solidifying incentives for fiscal discipline at all levels of government. FRLs are found to be useful in some cases, although the experience is not long enough to be certain, but they are clearly not necessary in every case, nor always sufficient to assure fiscal stability.

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## **Laws of Fiscal Responsibility for Subnational Discipline: The Latino Experience**

Since the 1990s many governments have intensified the search for mechanisms to escape from fiscal populism as a strategy for winning elections and retaining public office. As subnational governments in developing countries have gained fiscal autonomy,— spending responsibilities, tax bases, revenue transfers from the center, and the capacity to incur debt—their fiscal behavior has also caused concern. When subnational governments follow unsustainable fiscal policy, it can jeopardize the services they manage (but for which the central government may have ultimate political responsibility), the safety of the financial system and the international creditworthiness and overall macroeconomic stability of the country. Too often the central government then gets dragged in to provide bailouts, which can disrupt its own fiscal sustainability and reward the populist fiscal tactics of the recipient subnational governments.

National Governments have tried various ways to avert these problems. One way has been to pass a Fiscal Responsibility Law (FRL) that prescribes proper fiscal behavior for subnational governments (SNGs) and sets incentives – rewards for success or sanctions for failure in following the rules. Argentina, Brazil, Colombia, New Zealand, Peru, Russia and South Africa have done so, and India and Nigeria are considering proposals for such laws. Some subnational governments, as in Argentina, Canada, India and the United States, have imposed legal constraints on their own fiscal behavior, to reduce the temptation of state administrations to leave fiscal messes and to improve their creditworthiness in the markets.

This paper aims to shed light on the circumstances and character of FRLs that make a positive contribution to better SNG fiscal behavior, and to understand when these laws either add little or might actually distract and detract from other efforts to obtain prudent

subnational fiscal behavior. It considers the context of other laws and rules, and investigates alternate arrangements aimed at obtaining good SNG (and national government) fiscal behavior.

The first section considers why some institution like the FRL could be of use and from there refines the definition of the institution under consideration. The second section enumerates and categorizes the institutions, including but not limited to FRLs, that have served to discourage unsustainable subnational deficits. The third section reviews the institutions that four countries have used to deal with subnational deficits and evaluates the extent to which the institutions have succeeded. The sample—Brazil, India, Colombia, Argentina, and Mexico—includes most of the large developing countries with politically autonomous subnational governments and with recent problems of excessive subnational deficits. The final section draws conclusions about how the characteristics and circumstances of FRLs affect whether they are needed and whether they succeed in promoting subnational fiscal discipline.

### **1. What purpose could FRLs serve?**

Governments appear to be interested in FRLs for two related reasons: for an individual government to control its impulses to run excessive deficits and for a group of governments in the same country to make and enforce a mutual agreement that each of them would avoid running excessive deficits. In both situations the FRL would function as a commitment device—in the first case across time to commit future governments and in the second context across space to coordinate governments in various locales.

*Motivating Fiscal Sustainability.* In a normative theory of good government, people want to avoid the effects of fiscal crisis—inflationary finance, sudden increase of taxes, disruption of service, and increased borrowing costs—so their governments would equally

want to avoid the crises. Governments may fail to follow sustainable fiscal policies for a variety of reasons, however (see Alesina 1994 for a survey), and they have adopted various institutions to try to restrain themselves, including balanced-budget rules, autonomous central banks, and congressional oversight committees. Since the late 1990s, governments have added FRLs to the potential and actual arsenal.

*Dealing with Free Riders.* Suppose that multiple governments share the same currency, central bank, domestic credit market, and (at least to some extent) international credit reputation. Then they will share a common interest in sustainable fiscal balances for the country in the aggregate, to maintain stable prices, a healthy financial system, and good access to international credit. Individual governments' interests would diverge from the common interest, however, in that electoral pressures, etc., would motivate them to follow unsustainable, or at least risky, fiscal behavior. The individual government would bear only part of the cost of this, but would still receive all of whatever benefit accrued. They could benefit from this, however, only if (most of) the other governments continued to follow good fiscal behavior. So, there might be a prisoners' dilemma, or a situation where the equilibrium of isolated individual choices leads to a sub optimal outcome. All the governments would, therefore, benefit from having a system of rules to discourage such defection and free-riding.

In a federal country, one of the multiple governments —the federal government— already exists for the purpose (among others) of protecting the common interests, has much greater fiscal weight than the others, and typically has special powers, like running the central bank and regulating the financial sector. The federal government also provides transfers to the subnational governments, which often are the main source of SN revenue and give the federal government additional leverage over them. But this may not be enough.

Rules of revenue sharing and other rules of the federal system (like the constitution) may restrain the federal government's power over the SNGs. Political considerations may bias the decisions of the federal government away from the optimal; these could be the national political cycle or subnational ones. For instance when a state government of the same political party as is ruling at the national level faces a close election, the federal government might be inclined to condone the state's fiscal misbehavior by offering a debt bailout or rescheduling guarantee. Also, under some configuration of political institutions, the national executive might need to purchase blocks of legislative votes through provincial fiscal favors, in ways that also break the intertemporal Wicksellian connection. Thus the agreement to protect the common interest would not only need to restrain the fiscal behavior of the individual subnational governments but also restrain the behavior of the federal government.

Sub-national debt markets in both developed and developing countries have three important agency problems. First, sub-national borrowers as agents have an incentive not to repay their lenders as principals because they perceive that they will be bailed-out by the central government in case of default, resulting in moral hazard. Second, sub-national borrowers as agents have an incentive not to reveal certain characteristics about themselves to lenders as principals, resulting in adverse selection. Third, banks are implicit agents of the nation, entrusted to maintain the nation's payment system and creditworthiness, and they often abuse this trust by lending to uncreditworthy SNGs (in collusion with the SNGs) with the expectation of a national government bailout in case of trouble. The incidence of these agency problems varies considerably depending on the structure of the sub-national debt market in each country. For instance, the credibility and prudence of a no-bailout

commitment by the national government in the event of subnational default depends partly on whether the creditors to the defaulting subnational government are foreign or domestic.

Legislation with the label fiscal responsibility law do a wide variety of things, but the preceding discussion suggests several features of interest in this paper:

1. Institutions to restrain SN deficits by preventing them in advance and/or by imposing extra penalties that have effect more quickly and in addition to the normal consequences of fiscal imprudence.

- a. Institutions imposed by the national government on the SNGs, and
  - b. Institutions imposed by the SNGs on themselves in response to their fiscal environment, including most importantly the rules and behavior of the national government.

2. Institutions to restrain the federal government

- a. from running unsustainable deficits, or
  - b. from mitigating the consequences of subnational fiscal excesses.

## **2. Channels for strengthening subnational fiscal discipline**

To understand the role of FRLs in enforcing fiscal discipline, it is important to understand the range of institutional tools available for this purpose and, within each country of inquiry, to know what other institutions for fiscal discipline are in place. It is also important to understand the overall incentive structure and enforcement capabilities for subnational and national governments and their creditors.

*Incentives for prudence in the political system.* The political characteristics of the countries affect both the need for subnational fiscal-control institutions and their effectiveness. Indeed, to some extent the political factors that increase the need for an FRL also make it more difficult to pass one and to enforce it successfully. The case studies give

attention to several political dimensions: 1) a majority party of the executive in legislature versus coalition (parliamentary) or divided government (presidential); 2) strong party identities and unity, including closed-list nominations for legislature, versus weak parties and open lists; 3) autonomy of subnational governments constitutionally versus national government power to intervene and otherwise control; and 4) strong role for the national legislature and strong influence of governors over legislators, versus strong national executive authority. To the extent that the constitution and party system lead to a centralization of power, the country will have less need for special institutions to coordinate fiscal discipline across governments over time and between states.

*Deficit and debt controls external to the budgeting process.* Deficits and debt arise from the joint decision of governments and their creditors (including suppliers allowing extended payments), and those decisions are made in light not only of the rules governing issuance of the debt, but also the ex ante expectations about what will happen to the debtor and the creditors if payment difficulties arise—who will lose money or who will be forced into painful adjustment. The decisions of that lending moment—the original sin—become a *fait accompli* conditioning the subsequent decisions. This points to two important dimensions of control of government borrowing: 1) their type or timing—ex ante controls or ex post incentives—and, 2) whether they act on borrowers or lenders. Together these make a matrix with four cells, as in Table 1 below.

Ideally, any lending should be subject to constraints in all four quadrants. Relying only on ex ante constraints, without ex post consequences, gives irresponsible borrowers and lenders a big incentive to get around the initial hurdles and do transactions that will latter get bailed out. (This happened in Brazil in the early 1990s.) Relying only on ex post

consequences allow irresponsible (and large) entities to build up such large debts that the national government or the rest of the world will not have the nerve to enforce the consequences. Ex ante constraints are critically important in economies where banks and financial institutions are owned by governments and financial markets are not fully liberalized. Under such conditions credit allocation decisions are not strongly driven by considerations of protecting lenders interests. Relying only on constraints on borrowers means that lenders will still push loans and may find politicians with recklessly high discount rates willing to borrow despite the rules.

Table 1: Channels for control of deficits and debt

	For borrowers	For lenders
<i>Ex-ante</i> <b>controls</b>	<p><b>All governments:</b></p> <ul style="list-style-type: none"> <li>- debt ceilings</li> <li>- deficit targets</li> <li>- restrictions on international borrowing</li> </ul> <p><b>SNGs only:</b></p> <ul style="list-style-type: none"> <li>- regulation of SNGs’ borrowing, based on fiscal-capacity criteria (regulations by central government, central bank, or other institution)</li> </ul>	<p><b>All governments:</b></p> <ul style="list-style-type: none"> <li>- no direct central bank financing</li> <li>- restrictions on international borrowing</li> <li>- regulations by central bank or other financial supervision agency</li> </ul> <p><b>SNGs only:</b></p> <ul style="list-style-type: none"> <li>- credit rationing to states</li> <li>- increased capital requirements for lending to risky SNGs</li> </ul>
<i>Ex-post</i> consequences (as incentives for ex ante caution)	<p><b>All governments:</b></p> <ul style="list-style-type: none"> <li>- limits on central bank financing</li> <li>- no bailouts (from central government or from international community) and no debt workout without adequate conditionality</li> <li>- publication of detailed fiscal results</li> </ul> <p><b>SNGs only:</b></p> <ul style="list-style-type: none"> <li>- central government does not accept SNG debt</li> <li>- debt service withheld from transfers to SNGs</li> </ul>	<p><b>All governments:</b></p> <ul style="list-style-type: none"> <li>- strong supervision of banks</li> </ul> <p><b>SNGs only:</b></p> <ul style="list-style-type: none"> <li>- regulations require capital write-offs for losses from SNG debt</li> </ul>

For the constraint on borrowers, one can also distinguish between institutions—constitutions, FRLs, other laws, or well-established regulations—that encourage fiscal restraint. First, some of them set specific fiscal targets, whereas others emphasize procedures for setting targets and monitoring their implementation. Second, the specific targets could be for the bottom lines of fiscal performance—such as debt stocks and overall balances— or for

features of the budget that contribute to flexibility to adjust to shocks—such as the current balance or the share of spending going to investment or non-labor expenses.

Third, among FRLs, some are national laws that apply to all levels of government, or at least to the national and intermediate (state, provincial) levels. The FRLs in Brazil and Peru, and potentially in Colombia, are this type. From the SN point of view, these are top-down systems. In other countries, like India and Argentina, the national government passes an FRL only for itself, and hopefully (but not imperatively) this sets the framework, incentive, and example for the SNGs to pass their own FRLs voluntarily. These bottom-up systems are analogous to the successful federations that maintain fiscal discipline in through incentives, like the United States, Canada, and lately Mexico. They require more time to establish the credibility of the federal policies that set the incentives, and thus more time to judge their efficacy.

*Initial conditions.* Establishing an FRL or other institution to constrain SN debt and deficits will work only if the governments in question start from (or are brought to) a position where they do not have debt overhang. In other words, if the service on existing debt is already too large to pay realistically in the political economic situation, this attenuates greatly the incentive from an FRL to behave with fiscal responsibility. Consequently, a set of SN fiscal adjustment and debt rescheduling programs often must complement or precede the implementation of an FRL. To work, the programs must strike a balance between being sufficient to eliminate the debt overhang and being so generous as to seem to reward fiscal irresponsibility of the past (or to fiscally hamstring the national government).

### **3. Country institutions and experiences**

To help understand the role or potential role of a fiscal responsibility law, this section describes the institutional arrangements, history and political context of efforts to instill fiscal prudence at multiple level of government in the countries of our sample—Brazil, India, Colombia, Argentina, and Mexico. New Zealand, Canada, and India also have experience with FRLs. Brazil, New Zealand and Canada appear thus far as relative success cases, but with widely different circumstances. Brazil has one FRL for all levels of government; it uses both ex ante rules and legal penalties to contribute to the consolidation of a critical mass of consensus for fiscal prudence among powerful governors, with few party loyalties but strong influence over national legislators. executive. New Zealand is a unitary country without significant fiscal decentralization. Canada has no national-level FRL, but provinces have a lot of revenue autonomy and responsibility compared to other sample countries, and most provinces have passed FRLs on their own, to enhance their credibility in the markets. India is taking about a national-level FRL but does not have it yet, while some states have passed their own FRLs in order to look good with lenders (including the IFIs) and local voters. Colombia, a unitary country of “autonomous” departments, already has various laws constraining subnational borrowing, and to get more institutional backing for fiscal balance at the national level they passed an explicit FRL. It adds somewhat to the ex ante constraints on departments, although without strong enforcement provisions like Brazil, and sets up some transparency and accountability procedures for encouraging fiscal prudence at the national level. In Argentina, a collection of individual FRLs for the national government and for many but not all provinces initially showed promise but then failed, due to intra-party conflict, to non-participation by key provinces, and to other contradictory commitments that the FRLs failed to overcome. The FRLs emphasized ex ante rules, but without strong

enforcement and without universal application. Finally, in Mexico, we consider a case of fiscal prudence without a FRL even under consideration. The states have too much constitutional independence for the federal government to impose a top-down FRL, and so it is using financial sector regulations to motivate state-level prudence and has issued public decrees of new federal-level fiscal procedures, whose implementation a politically autonomous congress can monitor.

Each country case follows a similar format, to facilitate comparisons. First they discuss the political constitution of inter-governmental fiscal relations, for this sets the agenda of what needs to be done and what can be done by each level of government. The countries here are all presidential and except Colombia all constitutionally federal. The de facto political security of national and subnational executives and in the existence of other institutions (like congress and the courts) to check their discretion seem to be other important differences. The second section of the cases discusses the basic rules of fiscal the federation—allocation of tax and spending authorities and responsibilities, the transfer system, rules for borrowing (non-FRL), reporting and transparency institutions, and the history of SNG bailouts. The third section describes the country's history of SN debt problems and pre-FRL attempt to control it. The fourth section discusses what FRL(s) the country has, and the outcomes to date.

## **Brazil**

*Political constitution.* Federalism in Brazil revived with the return to democracy, which began in 1982 with the election of governors. Democratic elections for mayors of capital cities were held in 1985, a new congress with constitution-making authority was elected in 1986 and completed the new constitution in 1988, and the first direct election of

the president was held in 1989. Thus the democratic transition gave legitimacy to subnational governments before the federal level (Dias 1991; Hagopian 1996; Souza 1996). “The majority of the constitutional commission ... understood that democracy, in the area of public finance, demanded a weak federal government and strong subnational governments. In this way constitutional reform was occupied, on one hand, with the recovery of the powers of the legislative [branch] and financial autonomy of states and municipalities” (Afonso 1994). This view reflected the political background of most of the delegates: many of the senators were former governors and most deputies were former mayors.

Although the president has considerable power on paper in the constitution, his power in practice is circumscribed by the difficulty of marshaling party support. Parties are highly fragmented and lack discipline at the national level. Party decisions are determined more by what goes on in their own states than by what goes on in national politics. State loyalties lead politicians to coalesce in support of projects that will benefit their own state, regardless of their party. State governors command the loyalty of federal deputies, because their support is more useful than the support of the president. Legislative electoral lists are open (the party does not decide the number or priority of the candidates), unlike Argentina, so every candidate must compete against others from his party, depriving party leaders of a potential means for discipline. Few states have strong party machines to control this. Deputies also change parties frequently while in office, with 40 percent doing so in 1987–90 (Ames 1995a, 1995b). Because of their influence over national deputies and senators from their state, regardless of party, governors have the power to thwart or facilitate presidential designs, and they often use this power to demand special fiscal treatment for their states. The equal representation per state in the Senate (not unusual) combined with large minimum allocations

of deputies per state to give the low-population states much greater representation per capita than the large ones. This was compounded by an absolute limit on deputies per state that blatantly penalized the citizens of Sao Paulo. (The preceding paragraphs draw on Dillinger and Webb 1999.)

*Fiscal federal structure.* Not surprisingly, given the strong representation of SNGs in the 1986 congress, the constitution gave the SNGs a lot of authority and resources. The states got the best tax base—the VAT—and also got strong claims to revenue-sharing transfers out of the federal taxes. Neither constitution nor subsequent legislation, however, defined the majority of spending obligations of the SNGs, leaving them with considerable latitude to decide which responsibilities would be politically advantageous to take on.

The vertical imbalance of intergovernmental relations in the constitution was matched with important horizontal imbalances between the states. In some ways the small and poor states ganged up on a few large rich ones and abused them. The formula for revenue sharing was heavily tilted in favor of the north and center regions, which get 85 percent, leaving only 15 percent for the economic powerhouses of south and south-east, where the federal government collects most of its revenue. The south and south-east states have been able to make up the difference with their own VAT collections, but that did not absolve their feeling of being exploited unfairly. These non-cooperative outcomes in representation and revenue sharing set the stage for non-cooperation in fiscal prudence to protect macroeconomic stability, especially since it was the large rich states that had access to credit markets and thus the opportunity for serious fiscal imprudence.

*Debt history.* With this political context, and frequent lack of fiscal discipline by the national government, the emergence of SN debt crises is not surprising. From the beginning

of Brazil's political opening through 1998, there were three major subnational debt crises (Dillinger 1997). The agreements to resolve the crises tried to limit future SN deficits and the availability of financing for them. But the agreements also had four characteristics that in fact made the next crisis more likely. First, they reinforced the perception that the federal government was prepared to provide debt relief to any state requiring it. Second, they provided such relief in the form of rescheduling, rather than forgiveness, so that the stock of debt kept growing rapidly. Through the combination of grace periods, rescheduling, and debt service caps, the agreements reduced the debt service burden of sitting administrations, leaving the fiscal consequences to their successors. Third, there were limits on debt service largely that eliminated the expected future cost of current borrowing and interest capitalization for states already heavily indebted. Fourth, the debt relief bought out (without penalty) the foreign and private creditors to the SNGs and left the federal government holding the debt. Thus the SNGs suffered minimal consequences for their imprudence and their creditors suffered almost none, and so the ex ante constraints written in the rescheduling agreements were usually quickly and even enthusiastically evaded in the early and mid 1990s.

Even though the debt was a legal obligation of the states, the federal government had to float the ever-increasing volume of bonds required to finance it. The president and his economic team were the one constituency with a clear interest in bringing state debt under control, but the president himself was constrained. He was constrained by the weakness of party discipline and by the number of competing items on his legislative agenda. He would not exhaust his political capital on the state debt issue alone.

Although the large Brazilian states all ran excessive deficits, a few smaller states had good fiscal performance, such as Ceará and Paraná. Places with strong fiscal reform could benefit from attracting more private investment, so that a few chose to abstain from the low road of excess deficits and federal bailouts. Thus the individual states chose between extremes of good or bad fiscal behavior. The intermediate course of struggling through without substantial bailouts but also without strong enough performance to attract the attention of investors was not as attractive as the two extremes. The lack of a coordinating mechanism and of a critical mass of states with good behavior, which might have blocked bailouts in the early 1990s, created an incentive environment that caused some states like Rio Grande del Sur to switch from good to bad fiscal behavior.

*Prelude to the FRL.* In 1999-2000 there were signs of a potential end to the vicious cycle of failure in discipline and cooperation came to an end. The deeper political and economic incentives changed as well. Enrique Cardoso brought down federal deficits and inflation in 1994 when he was Finance Minister and then was elected president twice on the popularity of that achievement (even with its imperfections). That was an important seed-crystal to catalyze political support for fiscal prudence. Cardoso made political alliances with the governors of three of the four largest debtor states, including the most important, Sao Paolo. That would form the core of a critical mass of states ready to cooperate in fiscal restraint, making it worthwhile for additional states join at the margin of cooperation. To an individual state the value of non-cooperation (excessive borrowing) may have declined as well, from the effects of debt overhang and defaults driving creditors away from the market, and from the active interventions of the federal government, of which there were four in addition to the FRL.

Two measures focused on the SN borrowers and two on their creditors. For the borrowers there were a new Senate Resolution on limits for state borrowing and the framework law for individual renegotiations of SN debt. The constitution gives the Brazilian Senate unusually broad authority in state fiscal matters, with the power to approve or reject state borrowing requests, plus various controls over the central bank. The Senate often in the past represented the short-run interests of state debtors in raiding the nation's creditworthiness, although one might expect this federal institution to defend the common interest in fiscal discipline, as it seems to have done with two new Senate Resolutions in 2000[?]. In contrast to earlier resolutions, these latest ones set binding constraints on state borrowing and forbade some types of borrowing altogether.

Law 9696 law of 1997 for the renegotiations of state debt over the next two years set conditions that included targets for declines in debt and deficits ratios, ceilings for personnel spending and investment, growth in own revenues, and privatization of state enterprises. The law also stipulated penalties more strictly than in previous debt negotiations—no federal guarantees for state debt, interest rate penalties on existing state debt held by the federal government, increases in the debt service ceilings, and deductions of all debt service directly out of the revenue-sharing participations from the federal government. Although both these measures resembled previous ones, they set tighter limits and gave the government a stronger mandate to withhold transfers from states that failed to meet their agreements (Dillinger 2002).<sup>1</sup>

On the lending side, the National Monetary Council (CMN) ordered the Central Bank, as supervising authority for all domestic banks, to limit each banks total lending to the

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<sup>1</sup> Fulfillment of this law may have been uneven—gathering headlines for punishing the 1999 revolt by Minas Gerais, but perhaps not always being strict.

public sector and to prohibit bank lending to any state that is in violation of the debt and deficit ceilings of the Senate Resolutions or in default the federal government or to any other bank. The CMN resolutions specified penalties for any bank that violated the rules. Also, the privatizations required in the rescheduling agreements included the state owned banks, eliminating them as a source of debt financing. Singly, these measures would probably not have succeeded. The federal government might have gone weak again on enforcing the rules as they had in the past, or the Senate might have given in again to special state interests. Even as a group, although they covered the main channels for fiscal discipline, they might have failed to stem the momentum and precedents of state deficits and debt rollover.

*FRL.* Consequently Brazil also passed a FRL in May 2000, adding to the mix of policies that created a critical mass of states supporting cooperation (Alfonso 2002; Dillinger 2002).<sup>2</sup> The FRL is a unitary law, covering the federal and state levels. It sets minimum standards for state budgeting, personnel management, and debt management. The annual budget of each SNG has to be consistent with its multiyear budget plan and with the federal fiscal and monetary program. It systematizes and reinforces the restrictions on personnel spending, deficits and debt that were in the debt rescheduling agreements and other earlier measures. It also contains specific provisions for authorities in their final year in office. Some of its provisions were in the Law 9496 and the Senate resolutions. Although the bulk of the law pertains to ex ante conditions, it does reiterate the requirement that the federal government deduct from tax-sharing participation transfers any money owed by an SNG to the federal government and agencies. Debt and labor contracts in violation of the FRL are

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<sup>2</sup> A lack of horizontal accountability between the legislatures and the president, coupled with the president's inability to really on a supportive coalition in the congress, fueled expectations that the FRL's measures could be easily amended – or even aborted – in the future; this in turn made it possible to muster the legislative votes needed for its passage, notwithstanding high levels of political party fragmentation.

not legally valid, which would be negative ex post consequence for any lender who thus would thus lose its money.

Building from mandates established in SR 78, the FRL states that jurisdictions seeking loans must first apply through the Ministry of Finance and prove that they are in compliance with the new law. Any government that is not in accordance is dropped from further consideration. Furthermore any borrowing that has taken place above the threshold ceilings established by the senate is required to be repaid in full, not including interest. In the interim, governments are ineligible for discretionary fiscal transfers or federal guarantees and are prohibited from contracting new debt. The new law also prohibits governors and mayors from contracting obligations to pay within the last six months of their administrations, unless these can be paid off in the remainder of their term in office. And finally, it authorizes the federal government to garnish intergovernmental transfers or sub-national tax receipts a collateral for loans; this mechanism has worked in other cases, such as Argentina for a while in the 1990s, and discouraged local politicians from borrowing (Dillinger and Webb, 1998).

A companion law to the FRL specifies serious criminal penalties for officials who violate the rules. Critics point out the clumsiness and slowness of the Brazilian judicial system makes any convictions unlikely and thus unthreatening, but the experience so far suggests that officials also fear getting entangled in that legal morass. SNG executives seem to be using the FRL and its companion as an excuse to say NO to demands for special interest expenditures and transfers that would violate the FRL. Some state governments have put up posters telling the penalties, as reminder of why they are turning down special requests.

The fiscal performance of Brazil's SNGs has improved markedly over the last few years. The average ratio of debt to net revenue declined from 3.8 in 1998 to 1.9 in 2001

(Alfonso 2002). At the end of 2000, ten states still had deficit ratios above the FRL target; by the end of 2001 only six were out of compliance. They adjusted personnel expenditure, including public pensions, even faster; of the 18 states that were out of compliance with FRL targets in 2000, 13 managed to comply by the end of 2001. (BNDES, 10 May 2002)

Adjustment by SNGs continued in 2002. How much of this is due to the FRL? Some but not all. One cannot specify a fraction, because the states as a group seem to have jumped from a bad equilibrium to a relatively good one. The FRL contributed to that switch. The switch started before the FRL, but it contributed to sustaining the switch. It is still possible that the shock of national level macroeconomic instability could knock the system back to an uncooperative outcome, but the FRL seems to be contributing to the probability that the cooperation in SN fiscal prudence will continue.

## **Colombia**

*Political constitution.* According to the 1991 constitution, “Colombia is a state *social de derecho* organized in the form of a unitary decentralized republic, with autonomy of its territorial entities” (Article 1), but the departments do not have their own constitutions. The governors and mayors are constitutionally part of the executive branch of the nation’s government and have a duty to enforce national laws (Article 115). The formal government has traditionally been centralist, to offset the natural geographic fragmentation and to try to contain the centrifugal forces of strong special interest groups. Overlying the natural geographic fragmentation, strong non-regional interests dominate the political dialogue—some operate within the legitimate political system, like teachers and producers of coffee, cattle and sugar, while others are outside and challenging it, namely two guerilla movements, the paramilitaries, and drug producers. The interests within the system enjoy unusual

leverage to make demands on the government both because of the implicit threat to ally with illegitimate forces and because of institutional features they have learned to exploit.<sup>3</sup>

*Fiscal federal structure.* In Colombia, decentralization started in 1968 with the deconcentration of national revenues to subnational administrative units, with revenue sharing set by formula for most of the transfers and mostly earmarked for specific sectors (Bird 1984). Although it may seem unimportant that earmarked revenues were deconcentrated to subnational authorities appointed by the national government, congressmen at the head of local political machines actually controlled these funds and appointments.

The 1991 constitution (which also made the office of governor an elected post) and Law 60 of 1993 expanded the amount of revenues assigned to departments by broadening the base of the existing revenue-sharing system (the *situado fiscal*) to include all recurrent revenues of the government: the value added tax, customs, and income tax.<sup>4</sup> The Constitution and Law 60 committed the national government each year to expand revenue sharing with territorial governments and entities until it would reach nearly half of all current revenues by 2002. Cofinancing funds, transfers to municipalities for capital investment needs, remain important loopholes in the hard budget constraint for states.

Some taxes are under the control of subnational governments, and they receive royalties from mineral production, which go mostly to the producer departments and municipalities. About one-third of the royalties go into a fund that is redistributed across the country; no royalties go to the federal government (Sánchez and Gutiérrez 1995). This

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<sup>3</sup> For instance, the Senate is elected in a single national district, with each citizen able to vote for only one candidate. So senatorial candidates succeed by courting a particular special interest or large city where they can expect to garner enough votes to be among the 100 winners.

<sup>4</sup> Revenues from special funds were excluded.

innovation in the 1990s may have been aimed at strengthening the hand of local governments facing guerrilla threats, which often targeted oil production, but this rationale does not seem to have been explicit.<sup>5</sup> Problems of corruption in the use of these funds has prompted reforms in 2003 to earmark these funds for education. The most important revenue sources for subnational governments are the tax on alcoholic beverages by the departments and the tax on gross turnover of business and on property by the municipalities (Ahmad and Baer 1997; Bird and Fiszbein 1998). Except for a few large municipalities, the smallness of their tax bases makes it unrealistic for the national government to let the SNGs go into the credit markets without external constraint.

*Subnational Debt.* Consistent with the centralist tradition, subnational borrowing in Colombia in the '80s and before was uncommon, and required approval by the Ministry of Finance. However, in late 1980s and 1990s the trend towards political decentralization was accompanied by more freedom for domestic borrowing. In particular, there was no effective ex ante control of cash advances from banks, and subnational debt with the banking sector rose from 2.6% of GDP in 1991 to 4.6% in 1997.<sup>6</sup>

As a way to increase control over subnational debt by the central government, the so-called Traffic Light Law was passed in 1997. This law brought into effect a rating system for territorial governments, based on the ratios of interest to operational savings and of debt to current revenues. Highly indebted local governments (red light) were prohibited from borrowing, and intermediate cases (yellow light) were required to obtain permission from the

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<sup>5</sup> Perry and Rodríguez (1991, p. 77) note that this allocation goes against standard practice in the literature and that the reasons were “mas bien de índole pragmática y, si se quiere, política.” (“largely pragmatic and perhaps political”).

<sup>6</sup> For further details, see Dillinger, Perry and Webb (2001).

Ministry of Finance. In this way, the central government would be able to limit the growth of subnational debt.

The indebtedness law was not fully effective, however. According to Echavarría et al (2000), some governments with a red light rating obtained new financing without permission of the Ministry of Finance. “Out of 21 departments that required permission for new loans in 1997, 10 received new credit without permission from the Ministry [...] In order to be able to violate the law, departments presented defective financial information, and the financial institutions made superficial analysis of it. In addition, the Ministry of Finance gave its authorization in cases where it should have denied it.” (Echevarría et al, 2000, p.9). While there was the expectation that departments would transit from yellow to green, they often transited from yellow to red.

The importance of bank lending as a source of financing for subnational governments in Colombia makes bank regulation an alternative way to control subnational borrowing. The Superintendency of Banks has altered its requirements regarding provisions against non-performing territorial loans. After the bank borrowing expanded in 1993-1994, the Superintendency established that any subnational loan with over a year maturity had to be considered as risky and consequently should require some provisioning. These regulations were relaxed again in 1996, leading to two years of high borrowing. Starting in 1999, the debt of any territory with a red rating in the traffic-light law system must be fully provisioned, increasing the cost of those loans for banks. This combination may make the traffic-light law more effective.

*FRL.* In a new attempt to implement fiscal rules to stabilize subnational finances, Colombia passed Law 617 in 2000, which functioned in many ways as a Subnational FRL. It

is also still too early to tell whether the law brings about a structural change in fiscal outcomes, but the provisions appear to move in the right direction:<sup>7</sup>

- Primary current expenditure must be exclusively financed by non earmarked current revenues, and should not exceed a fixed percentage, depending on the state or municipality category,
- Expenditure for state legislatures is limited,
- Across the board cuts should be put in place whenever effective non-earmarked current revenues are lower than budgeted, and state and municipal central administrations are not allowed to make transfers to their public entities,
- There are strict limits to municipality creation. Proven non-viable municipalities have to merge.
- When subnational governments do not comply with the limits imposed by the Law, they have to adopt a fiscal rescue program to regain viability within the next two years.
- To promote transparency, there is an extensive list of characteristics and requirements for the election of governors, majors, legislators and their relatives.

In June 2003 the government passed a new Fiscal Responsibility Law applying to the national as well as the subnational governments. It specifies a process for setting budget targets and linking them to target ranges for debts and deficits. Regulations for the law build on the current practice of publishing quarterly fiscal results, defining deficits on the basis of cash revenue and accrual of spending obligations, and defining debt to include floating debt. The FRL sets a target to eliminate *reservas presupuestales* in two years. The other part of floating debt, *cuentas por pagar*, will be counted as regular debt and will thus be controlled by the fiscal/financial plan. To help with fiscal discipline at all levels, the FRL will prohibit the national government from lending to an SNG or guaranteeing its debt if it is in violation of *Ley 617 of 2000* or *Ley 357 of 1997*, or if it is in arrears on any debt service to the national

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<sup>7</sup> For further details see Oliva (2001).

government, Indeed, a subnational government with those fiscal violations may not legally borrow from anyone.

To discourage electoral cycles in fiscal policy, the FRL also prohibits any government from committing future spending (*vigencias futuras*) or increasing personnel spending in an election year. For the subnational governments there are additional restraints on deficits: eliminating the intermediate category in *Ley 357* (thus putting tight fiscal restraints immediately on SNGs that show signs of problems), and requiring that departments and large municipalities get satisfactory credit ratings from international rating agencies before they borrow. While some of these legal measures need further refinement, such as through their regulations, they represent important advances as long as they are enforced well.

The strategy for fiscal control in the proposed FRL differs between the national and subnational levels, because of the different constitutional constraints they face on fiscal policy. For the subnational governments, on the other hand, the Constitution specifies most of their revenue, via transfers, and gives them little leeway to raise more own revenue, so the proposed FRL strengthens the restraints on subnational deficits to complement the existing restraints on subnational spending, mostly in *Ley 617*. For the national government, where most of the fiscal problems have centered, the FRL increases transparency but still does not give the Ministry of Finance a hard budget constraint with which to enforce fiscal discipline in the face of special-interest demands, including those coming through SNGs on behalf of teachers and others. The Constitution, debt obligations, pensions, and other legal entitlements specify almost all outlays so for the it the FRL focuses on limiting the deficits so that the adjustment will have to concentrate on the tax side and thus eventually motivate

political restraint on spending. Control over spending will improve only if the new budget law (being drafted in 2003) gives the Ministry of Finance the authority in case of a revenue shortfall to curtail spending in order to meet the fiscal balance in the approved budget, and if less spending is legally pre-committed to special interests. The FRL cannot do it alone.

## **Argentina**

The discussion here of Argentina covers the late 1980s and the 1990s, after the restoration of democracy and before the fiscal implosion of 2001-02.

*Political constitution.* Like Brazil, Argentina has a federal presidential system with generally stronger presidential powers than in Brazil, although governors still have a lot of power. Members of the lower house (chamber of deputies) are directly elected, with the number of deputies determined by population, subject to a minimum per province. The minimum is five, which substantially increases the per capita representation of provinces with less population in the lower house as well as the senate (Jones 1998; Gibson, Calvo, and Falleti 1998). In elections for the lower house, each province serves as a single electoral district, with candidates running at large on party slates and with the number of seats assigned to each party based on its proportion of votes. The governor controls the party list, giving him strong power over the state delegation of his state party to the federal congress, perhaps even stronger than in Brazil where the lists are open. He typically takes the lead in negotiating bargains between the state and federal governments. Because his power is greatly enhanced when his party is in power nationally, the governor has an incentive to be part of his president's team. .<sup>8</sup>

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<sup>8</sup> The Argentina section draws heavily on Dillinger and Webb 1999, Webb 2003; Gonzalez, Rosenblatt, and Webb 2003; and Braun and Tommasi 2002.

Political parties are stable. Together, the Radicals and Justicialistas (Peronist) held more than three-fourths of seats in congress in the 1990s. The two parties are more disciplined than parties in Brazil, but less so than in Mexico. Candidates are nominated on closed-party lists chosen by the provincial party organization, which helps to maintain party discipline. The party-line pattern of roll call votes masks considerable bargaining with provincial political interests prior to the vote (Eaton 1998).

*Fiscal institutions.* Since the 1930s when the federal government abolished most existing provincial taxes and introduced national income and sales taxes, an increasingly complex system of revenue sharing (known as coparticipation has been the backbone of provincial revenues. In the 1990s coparticipation accounted for two-thirds of total provincial revenues, with wide variation between provinces. In the largest four provinces raise about half of their revenue (over 90 percent in the city of Buenos Aires), but under 10 percent in the smallest and poorest. General revenue sharing (coparticipation) is the largest single transfer, accounting for the bulk of transfers: 72 percent in 1991 and 57 percent in 1997. The pool of taxes subject to coparticipation consists of the federal income tax, value added tax (VAT), and excise and asset taxes; that is, of all the major federal domestic taxes other than social security and fuel. Before the transfer, several deductions are made from the provinces' share and are given to the national social security system and to several special funds for the provinces. Of those destined for special provincial funds, the largest deduction is to compensate for the costs of education and health services transferred to provinces and for the *Fondo Conurbano* to assist Buenos Aires province in providing basic services in the suburbs of Buenos Aires city. Deductions from the pool before coparticipation are also made to finance transfers to provinces in financial difficulty, but such transfers are limited to a small

percentage of the pool. Oil-producing provinces also receive directly a share of the royalties from oil companies.

The provincial share of revenues is theirs by right, and there is little explicit federal discretion in determining the amount or distribution of transferred funds. In the vast majority of transfers, the volume of funds subject to sharing is determined either as a fixed share of specified taxes or as a fixed amount in pesos. The distribution of funds among provinces is determined largely by formula, with coefficients fixed in the 1988 coparticipation law. Nevertheless, the dependence on intergovernmental transfers gives the federal government some leverage over the provinces. Because transfers can be created or altered through legislation, new transfers can be offered as a quid pro quo for provincial compliance with federal initiatives. This technique was employed extensively to achieve a series of fiscal agreements in 1991–94. Transfers also provide private lenders with instruments to ensure that debt service is paid, because debt service can be deducted from transfers at the source.

The decentralization law and the fiscal pacts with the provinces in the early 1990s clarified which functions, such as primary and secondary education, the states and municipalities had to take on. The provinces also had authority to cut their costs, although the usual politics and rules governing public employment did not make it easy. Also, in 1998 teacher protests at the national level led the federal government to intervene, putting a special tax on autos to pay for teacher wage increases.

*Subnational deficits and debt—control efforts.* In Argentina prior to 1991 provinces borrowed a lot, much of it from their own provincial banks, which then discounted the loans to the central bank, effectively giving provinces a share in the seigniorage and inflation tax. There were over 20 provincial banks, including two each in Mendoza and Cordoba. In 1990

they provided more than 60 percent of the credit needs of provincial governments, and the central bank lent massive amounts of new rediscounts to prevent the collapse of several provincial banks, due to poor loan recovery and massive overstaffing.

In the 1980s, with no strong leader in the national executive and a stalemate over how to distribute the costs of stabilization among the social classes and among governments, there was fiscal chaos. Provinces as well as the federal government had easy access to monetary financing; predictably, this led to hyperinflation. When hyperinflation in 1989–90 threatened to push the country further into underdevelopment, people grew desperate and were ready for strong policy medicine. The new president Menem then mustered political support for radical solutions. The keystone was the Convertibility Plan, introduced in April 1991, fixing the Argentine exchange rate to the U.S. dollar and requiring that the monetary base not exceed the dollar value of international reserves. The central bank's charter was revised to reinforce its autonomy, and strict rules prevented it from extending credit to the provinces directly or through their banks. This eliminated the central bank's role as lender of last resort and hardened the financial budget constraint on provinces.

The Menem governments followed largely a market-based strategy of coordinating fiscal discipline between levels of government: the central government would enforce hard budget constraints and force the provinces to pay their debts *ex post*. This was to provide incentives for voluntary *ex ante* prudence about borrowing at the subnational levels. During the 1990s the strategy sort of worked. Some provinces, not most of the biggest, over borrowed in the early 1990s, then had to suffer consequences in the 1995 economic turn down (only slightly softened by federal intervention), after which they should have learned a lesson in the virtue of prudence. But the quick resumption of growth took away most of the

pain; provinces resumed borrowing, especially Buenos Aires. By the end of the 1990s, the absence of the ex ante fiscal controls had allowed a number of provinces to over borrow, and according to the Menem-Carvalho (by then departed) strategy some of them would have suffered painful consequences.

The successes of the Menem-Cavallo team in getting the provinces to go along with the national adjustment program resulted from an unusual conjuncture of historical opportunities. Provinces followed a pattern of fiscal restraint where the provincial government was of the same party as the national president. Indeed this pattern seems to go back to the 1980s as well (Jones, Sanguinetti, and Tommasi 1997). Next to the province of Buenos Aires, Santa Fe was the most important case of a Justicialista province adjusting promptly after the start of stabilization. Getting those two to adjust before the 1995 crisis provided a critical mass of fiscally sound provinces and allowed the central government to take a hard line in forcing the other provinces to adjust. By the late 1990s, however, the political context was changing, as the Justicialistas gained the important province of Cordoba but rifts within the party put all-important Buenos Aires effectively in the opposition.

*FRLs.* At the national level, faced with a deteriorating budget balance and growing debt payments, the Argentine Congress approved a Fiscal Solvency Law in September 1999. This law required achieving budget balance at the national level of government by 2003. Apart from establishing numeric limits for the central government's fiscal deficit, it also limited the growth of expenditures. Furthermore, the law stipulated the adoption of pluriannual budgeting, the creation of a Countercyclical Fiscal Fund, and the implementation of transparency measures to increase the availability of information regarding the state of

public finances. Although the law did not include conditions for subnational governments, it invited the provinces to pass similar laws at the subnational level.<sup>9</sup>

Regarding the limits on budget deficits, the Law established that fiscal balance had to be reached no later than 2003, and it set nominal ceilings for the national-level non-financial public sector deficit between 1999 and 2002. The Fiscal Solvency Law was modified by the 2001 Budgetary Law, which relaxed the deficit ceilings, and extended the date at which budget balance should be achieved until 2005. Table 2 shows the limits imposed by the Fiscal Solvency Law and its modification, together with the actual budget outcomes between 1999 and 2001. Contrary to the optimism expressed by some analysts of the Argentine case,<sup>10</sup> the rule was broken in every year.

Table 2: Compliance with the Federal Fiscal Solvency Law

Year	Limits (as % of GDP)		Observed
	1999 Fiscal Law	2001 Budget Law <sup>11</sup>	
1999	1.9%		3.1%
2000	1.1%		2.5%
2001	0.5%	2.5%	4.0%
2002	0.3%	2%	
2003	0%	1.3%	
2004	0%	0.9%	
2005	0%	0%	

Source: Fiscal Solvency Law and Ministry of Economy

The new government of Fernando de la Rúa, taking office in late 1999, was not prepared with ideology or political party cohesion to take a strong line in enforcing fiscal limits on the provinces. In addition, the recession (after the big Brazilian devaluation in 1999) had worsened the fiscal situation of governments at all levels. Another agreement –

<sup>9</sup> The exclusion of limits on subnational governments was a fundamental weakness of the rule. In a country with a federal fiscal system as the one in Argentina, fiscal rules would only make sense if they encompass all relevant governmental levels. Otherwise, they would simply be non-binding. It would be like telling a person that they can only spend \$500 a month using their left hand.

<sup>10</sup> See, for instance, Kopits, Jimenez and Manoel (2000).

<sup>11</sup> Values are estimated, because the Law establishes nominal ceilings for the deficit, not for the deficit as percentage of GDP.

*Compromiso Federal* -- was reached with the provinces. The main focus of the agreement this time was on the calculation of transfers; however, there were also some general commitments to provincial tax harmonization and fiscal transparency. A major component of the Federal Agreement was that during the year 2000, the provinces would receive a fixed amount in automatic transfers.<sup>12</sup> This provided the provinces with predictability in income, but the amount was also designed to allow the federal government to keep a larger share of incremental revenues expected both from an economic recovery and an increase in federal tax pressure.

This arrangement represented a sizable *expected* loss to provinces in terms of total transfers. To attract the provinces, debt-restructuring deals were offered to smaller provinces, and the federal government promised that they would facilitate larger provinces' debt restructuring via private banks and the multilateral development banks. Plus, they would finance part of provincial employee pension systems' deficits if reforms were made to make the systems consistent with the national system. (Many smaller provinces had already passed their pension systems to the federal government; however, this feature was attractive to the larger provinces that still have their pension systems.)

One year later, this agreement was followed by a more comprehensive *Compromiso Federal Por El Crecimiento y La Disciplina Fiscal*, signed in November 2000 by all provincial Governors, except one. The agreement included a number of clauses for provincial reforms in the area of state modernization, budgeting and the transparency of fiscal accounts. It established a timetable for switching permanently to the moving-average concept for stabilizing transfers, with guaranteed minimum amounts over a transition period.

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<sup>12</sup> Virtually all automatic transfers were included – both the general revenue-sharing pool and tax-sharing arrangements. This represented a *de facto* simplification of the labyrinth of automatic transfers that had evolved

This contributed to substantial fiscal and political stress in late 2000, and ultimately the federal government was not able to transfer the full guarantee and arrears accumulated.

Several provincial governments followed the national example and passed FRLs. The provisions of the laws differ across provinces, as well as in the degree to which they were adhered to, even before the fiscal collapse in 2001. Appendix Table A-1 summarizes the main characteristics of the existing subnational rules. The national law has explicit limits on the annual deficit, current expenditure, and the overall public debt, and requires pluriannual budgeting, a stabilization fund, and various fiscal transparency measures—features favored by the recent literature on fiscal rules. Only one state’s FRL, Formosa, has provisions for all these, although all the provincial FRLs have limits on the deficit *or* overall debt, and most have both. More importantly, the city of Buenos Aires and three of the four large provinces did not pass any FRL. They contain well over half of the nation’s economy, and their non-participation undercut any hope for the system of FRLs to assure that no government would spoil the common good of fiscal prudence.

Compliance even with the laws that were passed has been uneven in terms of debt and deficit performance. (Appendix Table A2 shows the deficit and expenditure targets allowed by law in each province and the actual outcomes for 2000.) Only 5 out of 11 provinces that imposed a hard budget constraint actually fulfilled their commitment. Out of the five that complied with the law, two of these, Cordoba and Tucuman, had been achieving the objective stated in the law for several years, so the law appears more like a reflection of pre-existing underlying political agreements. With respect to limits on expenditure, only five out of eight provinces that imposed limits complied with them in 2000. Since a government that passes an FRL would normally have a high commitment to the goal, a commitment that

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in the 1990s.

it hope to pass on to subsequent administrations, the low initial achievement rate does not bode well.

The tradition of not respecting rules goes beyond the FRLs. For instance, sixteen of 24 provinces have constitutional limits regarding the ratio between debt service and total revenue. These limits vary between 20% and 25% of the total revenue. However, in 2000, only 10 of the 16 provinces complied with those limits, with results for 2001 being much worse. (See Appendix Table A3)

*Conclusions.* Argentina exhibits both long-standing and recent fiscal rules, many following international best practices, which have been broken. Several provinces did not comply with their commitments in the face of declining tax revenues, signaling to creditors the inability to maintain fiscal discipline and thus contributing to Argentina's overall fiscal crisis. The main immediate reason for the failure of the FRLs was the fiscal collapse that started at the national level. The federal FRL not only lacked enforcement power, but it also sat in the context of many legally inflexible spending obligations, most notably debt service and subnational transfers denominated in dollars or pesos linked to dollars. Also the provincial FRLs had shortcomings that might have proven fatal if the collapse at the top had not come first; they lacked enforcement power and a critical mass of states had not passed them—BA province, BA city and Santa Fe—the same entities that had formed the core group for fiscal adjustment in the early 1990s. The *Compromiso Federal* of 2000 did include virtually all provinces but did not have contingencies to assure fiscal sustainability in downside scenarios of growth. It arranged to share benefits of growth but not to share the cost of recession. All the governments were benefiting from the public good of a stable currency, and using it to access credit markets, but they failed to appreciate the fragility of the asset and

the need to coordinate efforts to avoid overuse. Conflicts over corruption, the annual distribution of transfers, and other issues proved too much of a distraction.

## **Mexico**

Among the countries discussed here, Mexico alone neither has an FRL nor is considering one at the national level. Many states have laws, or sometime just traditions, regarding the build-up of deficits or surpluses (rainy-day funds). But none has what we call an FRL. Nonetheless, new institutions of SN fiscal discipline have emerged in Mexico since the late 1990s, which seem to be achieving the objectives of FRLs by other means.

*Political constitution.* Although Mexico constitution since the early 20<sup>th</sup> century has devolved considerable autonomy to the states, and power to the congress, in the 1970s and 80s the dominance of the PRI party and the power of the president within the party effectively short-circuited that federalism and balance of power between branches of government. The president controlled the party apparatus while he held office, and the party controlled the career of every politician, since no one could be re-elected to his current office and the party's selection was always the key to the next job. This effective centralization evolved over several decades and was institutionalized by the 1980s (Cayeros, Magaloni and Weingast, 2002).

For reasons unrelated to SN finances, the hegemony of the PRI ended at the state level in the late 1980s and the 90s, and at the federal level in the late 1990s, culminating in a change of party in the presidency for the first time in seven decades. Three major parties now contend for office and share power in the national congress and many state congresses, which requires the president and many governor to negotiate their budget and other legislation with the opposition.

*Subnational debt.* In the time of PRI hegemony, subnational debt was guaranteed by the federal government which also kept a veto power over issuing it. Unsustainable subnational debt would lead to a bailout, but also to career damage in the party for a governor. Thus the problem of SN fiscal discipline largely merged with the overall issue of national fiscal discipline. Ex ante controls and ex post consequences existed and usually kept subnational debt at sustainable levels, but the important controls and consequences were outside the formal rules and based on personal political connections. Since the 1990s, however, the old way of dealing with SN debt would no longer work in the new environment, and the federal government started to recognize this and change the regime in the 1990s. The general debt and economic crisis of 1995 also included the states, who then got relief through rescheduling into long-term inflation-indexed debt at affordable but positive real interest rates and through four years of assistance payments (from the president's discretionary fund and in addition to the other, regular transfers). To avoid a recurrence, the states each had to agree to a fiscal adjustment program designed in the Secretariat of Finance (SHCP), which monitored compliance prior to disbursement of the annual tranches of assistance. While politically favored states had to adjust less, the arrangement set a precedent of fiscal consequences and brought most states to a good financial situation by the end of the 1990s. The indexed debt that the banks were force to accept helped them avert total ruin and collapse of the system, but illiquidity of the assets and low return inflicted some penalty on the borrowers as well. The government also ended its policy of guaranteeing subnational debt, although as a transition it agreed to accept and execute contractual mandates by which the borrowers pledged their revenue-sharing transfers as collateral for the debt service.

*Non-FRL debt control.* By 1999 the government could no longer get the president's discretionary fund through the opposition-dominated congress and, without such incentives, could not dictate fiscal prudence to the governors in return for assistance with debt rescheduling. While the existence of discretionary executive fund for debt rescheduling generally detracts from hard budget constraints for states, during the 3 years after the 1995 crisis it was used to bribe most states into fiscal adjustment. Nonetheless, the federal government saw the need for change toward a more traditional hard-budget constraint and so brought in a whole new system, starting in 2000. The new borrowing framework has four key elements:

1. Eliminating discretionary transfers from the federal government, at least those at the discretion of the executive.
2. Ending SHCP's role as *fideicomiso* for collateralizing debt with participaciones. Lenders and the SN borrowers may and are encouraged to organize their own fideicomisos for this purpose, which they finally started to do after a couple of years of negotiation; the absence of direct federal government involvement is expected to reduce the administrative ease and thus the likelihood of an informal bailout.
3. Giving commercial and development banks ex ante signals about the riskiness of state debt, by making the debt subject to the same borrower concentration limits as other debt and by requiring that capital-risk weighting reflect riskiness, as indicated with international credit ratings.
4. Giving strong incentives for borrowers publish their fiscal and financial information.

The new Mexican regime seems to be potentially complete, with coverage in all four quadrants of table 1. The first two are commitments from the federal level that it will in the future let states and lenders face the market consequences of excess deficits, which should make them less attractive ex ante. The third and fourth elements aim both to deter states in advance from excess borrowing and to reward states that follow prudent policy. The credit

ratings have become badges of good behavior with positive value in the electoral arena, independently of their effect in improving access to credit and reducing its cost. The system is very new, however, and only after it has endured a few tests will one be able to say whether the ex ante controls and the commitments to impose consequences were adequate.

Although Mexico does not have a national FRL, state governments have incentives now to make their budgets and balance sheets attractive to voters, credit rating agencies, and lenders—taking the sort of measures that an FRL might demand. The federal government has no constitutional or legal authority over them in fiscal affairs, and bribing them all to give such authority to the federal government would be prohibitively expensive. In Brazil, the high debt of the SNGs to finance their high debts gave the national government leverage to demand acceptance of the FRLs. In Mexico only a few states have high debts, such as the State of Mexico, which is undertaking a custom-designed structural adjustment program to improve its efficiency and make its finances sustainable. A one-size-fits-all set of target ratios would probably not have done as well in Mexico, even if it had been politically feasible.

## **5. Conclusions**

While there is much that FRLs might do, the evidence of their effects is still slight, as only a few countries have actually tried them, and only recently. While political consensus for fiscal prudence is clearly a necessary condition to launch a successful FRL, the test of its effective implementation comes when the consensus breaks down, and then one sees whether the institution works to help the remaining stabilization champions restrain the fiscal excesses that the populists might want.

Evidence from the sample here indicates that FRLs are neither necessary nor sufficient for achieving fiscal prudence at multiple levels of government. They can be useful as mechanisms to coordinate and sustain commitments to fiscal prudence, but they are not a substitute for commitment. They should not be viewed as ends in themselves, perhaps to be bought with fiscal favors.

In Brazil, the FRL's contribution seems to be positive, adding on to the collection of other measures to shore up a coalition of states with the federal government in support of fiscal prudence. Still the story is very short there, covering mainly the latter part of the Cardoso administration, which brought together a conjunction of stabilization commitment by the president and a political alliance with most of the important states, including the largest. Perhaps the real tests will come in the new Lula administration. Such surge of stabilization commitment also prevailed in Argentina in the mid 1990s, when its prospects for fiscal prudence looked good (Dillinger and Webb 1999). When Argentina came to its version of the FRL at the end of the 1990s and into 2000/01, however, the conditions were much less favorable. Political relations between the federal government and Buenos Aires province (relatively much larger than any Brazilian state) had strongly soured, leading that state and most other large ones to stay out of the FRL coalition. Thus one could say that Argentina never put in place a full FRL system even on paper, and the limited one certainly failed. The experience in Mexico seems to show the possibility for achieving the objectives of an FRL by other means.

Even when FRLs are effective, they cannot do the job alone. The potential contribution depends on how well it complements the rest of the institutional framework for SN fiscal restraint. In Brazil a number of supportive measures came in advance—making

labor and pension laws more flexible, giving subnational governments substantial tax bases, using rules for debt renegotiations to reduce salary bill as a share of revenue, etc. In Colombia, the national government has passed a number of measures to restrict subnational borrowing and inflexible spending, so the FRL will have that support. At the national level, Colombia is still introducing the budgeting reforms to be consistent with the new FRL. By contrast, in Argentina, the partial system of FRLs failed when the federal government had boxed itself in with the convertibility law, debt service, and commitments to floors for transfers to provinces, all of which made the targets of the FRLs ever harder to meet during the worsening recession.

It seems critical that the FRL or some other measure must assure that the national government acts as a good model for fiscal prudence, both to avoid stressing financial markets and to meet its fiscal commitments to the SNGs.

The effectiveness of an FRL also depends on how well it can be enforced. The two are linked in that countries with weakness in their SN fiscal constraints are likely to also have weak enforcement mechanisms for a potential FRL.

The needs for national level discipline and for enforcement mechanisms might be arguments for a single comprehensive FRL with top-down rules for all, as in Brazil and Colombia. But getting everyone to agree on the same document, when the national government does not have this constitutional authority (like Mexico, Argentina, India and Canada), could be costly in political capital and fiscal bribes. Going the multi-law route, as was tried in Argentina, could work if the national level law or practice both sets a proper example and puts in place incentives—hard-budget constraints—that motivate the SNGs not only to behave fiscally but also to adopt institutions to assure that in the future. In a sense,

this was the strategy in the US, where the no-bailout by the Feds since the early 1800s set up the incentive for many states to constitutionally require budget balance. There, as in Canada and India, the subnational FRLs are endogenous outcomes to the fiscal regime setup from the national level. Either way, whether or not a national FRL sets detailed rules for SNG fiscal policy, the national government (with or without an FRL for itself) has to set hard-budget constraints on the SNGs that enforce ex post the rules for their fiscal prudence.

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